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Supreme Court of the United States

October Term, 1965

No. ..252

Estate of LILLIAN VIRGINIA SPERLING, Deceased,
WARREN RICHARD SPERLING, Administrator,

Petitioner,

AGAINST

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

ON APPEAL FROM THE TAX COURT OF THE UNITED STATES

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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Supreme Court of the United States

OCTOBER TERM 1964

No. .....

ESTATE OF LILLIAN VIRGINIA SPERLING, Deceased,
WARREN RICHARD SPERLING, Administrator,
Petitioner,

AGAINST

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

To the Honorable, The Chief Justice and Associate Justices of the Supreme Court of the United States:

Warren Richard Sperling, Administrator of the Estate of Lillian Virginia Sperling, petitioner herein, prays that a writ of certiorari be issued to review the judgment of the United States Court of Appeals for the Second Circuit entered in the above entitled case.

Opinions Below

The opinion of the Tax Court was not officially reported.

The findings of fact and memorandum opinion of the Tax Court was filed on September 26th, 1963 as T. C. Memo. 1963-260 in Docket #88167 and is printed at pages 99a-120a in the Appendix in the Court of Appeals.

The opinion of the Court of Appeals for the Second Circuit is printed in Appendix "A" annexed hereto.

Jurisdiction

The judgment of the Court of Appeals was entered on January 22nd, 1965 (R. 155a-156a) and is printed in Appendix "B" annexed hereto.

A timely petition for rehearing was denied on March 15th, 1965 (R. 190a-193a).

The jurisdiction of this Court is invoked under Title 28 U. S. Code, Sec. 1254, and Section 7482 (a) of the Internal Revenue Code of 1954.

Questions Presented

1. Does the judgment of the Court of Appeals accord to the Petitioner due process and equal protection of the law when it sustains the deficiency of the Respondent against the Petitioner, who dealt in merchandise, which was an income producing factor, and who kept his books on the cash receipts and disbursement method, without first placing the Petitioner on an accrual basis, all contrary to the Internal Revenue Code and the Respondent's own regulations?

2. Can the Respondent Commissioner assess a deficiency against the Petitioner without first placing his books on an accrual basis in order to clearly reflect his income?

3. Can the Respondent Commissioner refuse to allow to the Petitioner as part of his cost of goods sold metals clearly shown to have been in his hands and processing charges paid by him, but for which no credit was given as part of the cost of his goods sold?

4. May the Respondent Commissioner refuse to allow the taxpayer, as part of his costs of goods sold, cash purchases shown to have been made by him during the taxable years involved?

Constitutional Provision

The constitutional provision involved is the due process clause of the Fourteenth Amendment to the Constitution which provides in pertinent part as follows:

> "* * * nor shall any person * * * be deprived of * * * property without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws * * *".

Statutes and Regulations Involved

1939 Internal Revenue Code

Sec. 22—Gross Income . . .

(c) Inventories. Whenever in the opinion of the Commissioner the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Commissioner, with the approval of the Secretary, may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

Sec. 41—General Rule

The net income shall be computed upon the basis of the taxpayer's annual accounting period . . . in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method em-

ployed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. . . .

REGULATIONS 118—1939 CODE

§39.22(a)-5. GROSS INCOME FROM BUSINESS

In the case of a manufacturing, merchandising, or mining business, "gross income" means the total sales, less the cost of goods sold, . . .

§39.22(c)-1. NEED OF INVENTORIES

In order to reflect the net income correctly, inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase or sale of merchandise is an income producing factor. . . .

§39.41-2. BASES OF COMPUTATION AND CHANGES IN ACCOUNTING METHODS

(a) . . . For instance, in any case in which it is necessary to use an inventory, no method of accounting in regard to purchases and sales will correctly reflect income except an accrual method. . . .

1954 INTERNAL REVENUE CODE

Sec. 446—GENERAL RULE FOR METHODS OF ACCOUNTING

(a)—*General Rule*—Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

(b) *Exceptions*—If no method of accounting has been regularly used by the taxpayer, or if the method used does

not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary or his delegate, does clearly reflect income.

(c)—*Permissible Methods*—Subject to the provisions of subsection (a) and (b), a taxpayer may compute taxable income under any of the following methods of accounting—

(1) The cash receipts and disbursement method;

(2) An accrual method;

(3) Any other method permitted by this chapter; or

(4) Any combination of the foregoing methods permitted under Regulations prescribed by the Secretary or his delegate. . . .

SEC. 471—GENERAL RULE FOR INVENTORIES

Whenever in the opinion of the Secretary or his delegate, the use of inventories is necessary in order clearly to determine the income of any taxpayer, inventories shall be taken by such taxpayer on such basis as the Secretary or his delegate may prescribe as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income.

REGULATIONS—1954 CODE

§1.162-1. BUSINESS EXPENSES

(a) *General Rule*— . . . The cost of goods purchased for resale, with proper adjustment for opening and closing inventories, is deducted from gross sales in computing gross income. . . .

§1.446-1—General Rule for Methods of Accounting

(a) *General Rule*— . . . (2) . . . No method of accounting is acceptable unless, in the opinion of the commissioner, it clearly reflects income. . . .

(a)(4)(i)—In all cases in which the production, purchase, or sale of merchandise of any kind is an income-producing factor, merchandise on hand . . . at the beginning and the end of the year shall be taken into account in computing the taxable income for the year. . . .

(c) *Permissible Methods* (1) *In General*. . . .

(ii) . . . Accrual Method. . . . .

. . . The method used by the taxpayer in determining when income is to be accounted for will be acceptable if it accords with generally recognized and accepted income tax accounting principles and is consistently used by the taxpayer from year to year.

(iv) *Combinations of the Foregoing Methods*—(a) . . . a taxpayer using an accrual method of accounting with respect to purchases and sales may use the cash method in computing all other items of income and expense. . . .

(c)(2) *Special Rules*

(i)—In any case in which it is necessary to use an inventory the accrual method of accounting must be used with regard to purchases and sales unless otherwise authorized . . .

§1.471-1. *Need for Inventories*

In order to reflect taxable income correctly, inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase or sale of merchandise is an income producing factor. . . .

EXCERPT FROM A. R. R. 217, 3 CUM. BULL. 76, 78-79 (1920)

Printed herein at pages 22-23.

Statement

The petition in the Tax Court involved the years 1951 to 1954 inclusive, but the Tax Court sustained the Petitioner as to the years 1951 and 1952 and found a deficiency only for the years 1953 and 1954 which are at issue.

The real taxpayer in the case at bar was Eugene Sperling, the deceased husband of Petitioner's intestate, Lillian Virginia Sperling. During the years involved and up to the time of his death in 1956, he was engaged in the business of buying, selling, processing and refining precious metals, scrap metals and "sweeps". "Sweeps" so called are sweepings collected by jewelry manufacturers or polishers in the process of manufacturing, which is periodically sold to refiners such as the taxpayer herein, who processed them into various kinds of metal (103a).

During the taxable years involved (the Korean War) there was a shortage of metals by reason of which there was created a black market, in which metals were bought and sold for cash (103a, 104a). Practically everybody doing business with Sperling wanted to do it on a cash basis, and he was compelled to do likewise (51a, 81a, 82a). During the years 1953 and 1954, Sperling had issued $34,569.39 and $15,190.00 checks respectively, payable to "Cash", for merchandise purchases which were disallowed by the Respondent (106a).

During the years at issue in the Tax Court, the taxpayer had done by far the greatest part of his business with one Kastenhuber & Lehrfeld Inc. (referred to as K & L) who were also in the business of processing precious metals (104a).

Alvin D. Silber, a Certified Public Accountant, was retained to make an examination of the books and records

of Sperling (37a). He procured from K & L the ledger sheets of their account with Sperling for the business done during the period in question (Petitioner's Exhibit 9) (37a, 67a).

These records were identified by the bookkeeper of K & L, who worked on the books and had personal knowledge of the transactions between her firm and Sperling (32a, 33a). She explained the meaning of the various debit and credit entries in the account (34a).

Silber examined this account, analyzed it and made a summary of it (Petitioner's Ex. 10). He broke down the respective debits and credits of the ledger sheets and classified them into cash, processing charges, metals, etc. (37a, 40a). This exhibit was verified by tracing the cash payments made by K & L to Sperling into Sperling's books, where they were recorded item for item; and likewise the payments made by Sperling to K & L were similarly traced. He satisfied himself as to the accuracy of these records by comparison with Sperling's books (45a, 46a). Exhibit 10 showed that the total metals received by Sperling from K & L during the four year period amounted to $325,856.29; and the total metals received by K & L during the same period amounted to $277,811.41. The difference between the two, $48,044.88 represents metals purchased by Sperling from K & L over and above what he sold to K & L; but Sperling's books showed no record of this $48,044.88.

Silber, a Certified Public Accountant testified that Sperling had this merchandise on hand in his business throughout the four year period, without any record on his books, and that he did not receive credit for this merchandise as part of his cost of goods sold. (Transcript of testimony at the trial 25, 42a, 43a, 46a, 91a).

Obviously, under the cash receipts and disbursements method employed by Sperling in his books, the cost of

goods sold in Schedule C on the tax returns did not include any charge for the processing of metals by K & L, and the Respondent failed to give the taxpayer credit for any part thereof (110a).

Despite this proof, the Tax Court (and the Court of Appeals) failed to make any allowance in the taxpayer's cost of goods sold for this merchandise (110a). Exhibit 10 showed that the net charges for processing by K & L to Sperling for the years 1953 and 1954 amounted to the sums of $7,552.94 and $6,248.61 respectively.

That there was a black market during the taxable years in question is undisputed (104a, 112a, 113a). Platinum, which was the main material dealt in by the taxpayer, was legally selling for $105.00 an ounce, while on the black market it sold for $150.00 an ounce. Obviously, those desiring to deal in platinum had to deal in cash in the black market (83a). Practically everybody doing business with the taxpayer wanted to do business on a cash basis (81a). Such persons were specifically named by the witnesses (50a, 51a, 81a, 82a).

One of the witnesses, Jamison, an employee of Sperling from 1949 to 1956 (throughout the taxable years in question) went with Sperling to pick up "sweepings" and bring them back to the place of business. He was generally familiar with the business operations and he knew of his own knowledge that Mr. Sperling bought metals for cash (49a, 50a). At times he was not permitted to leave the customer's premises until the customer had counted the cash, and only then he could remove the "sweepings" (50a). Two checks (Exhibits 11 and 12) were endorsed by him, returned to Sperling who put the cash in an envelope and gave it to him to pick up "sweeps" (51a).

The taxpayer Sperling told Sherman, the Revenue Agent, who examined his returns, that the cash checks

were for purchases, but he would not reveal the names of the customers (97a).

The testimony of Warren Sperling was to the same effect. Two checks (Exhibits 13 and 14) bearing his endorsement refreshed his recollection that the cash was used for the purchase of merchandise (57a, 58a). In fact, Exhibit 14, a check for $491.25 endorsed by Warren was the final check in a series of payments of a Nassel bill (Ex. 15) (82a, 83a). These cash transactions were not unusual. Warren frequently saw his father write checks, go out of the office, come back with money and pay it to customers (83a, 84a).

However, both the Tax Court and the Court of Appeals disregarded this evidence, although it was not impeached.

The evidence showed that a large cash business was done with two customers for Sperling, to wit, Nassel and Rudish (66a, 67a, 78a, 79a).

While a large cash business was done, nevertheless, by far the greater business was done on a credit basis.

The "cash" business done by the taxpayer during the two years 1953 and 1954 can easily be seen from the following comparison:

	1953	*Percentage*	*1954*	*Percentage*
Cash Sales [1]	59,258.00	13%	–0–	–0–
Total Sales	448,258.25		258,653.67	
Cash Purchases	34,569.39	8%	15,190.00	7%
Total Purchases	411,258.25		221,841.50	

[1] The Cash Sales are listed in the Supplementary Appendix annexed to the Petititoner's Reply Brief, and the total sales and purchases are shown in the Petitioner's Original Appendix, page 109a.

Thus, it can be seen that the "cash" sales in 1953 were only 13%, and "cash" purchases were only 8% in 1953, and 7% in 1954. Thus, over 90% of the business was done on credit.

It is undisputed in this case that the taxpayer herein maintained inventories (109a, 117a) and kept his books on the basis of Cash Receipts and Disbursements (104a, 113a-114a). He did not keep his books on an accrual basis (117a). K & L's books were kept on the accrual basis (117a).

Argument

Section 41 of the Internal Revenue Code of 1939[2] and Section 446 of the Internal Revenue Code of 1954 provide that taxable net income shall be computed under the method of accounting regularly employed by the taxpayer in keeping his books, but if that method does not clearly reflect income, the computation of taxable income shall be made under such method as in the opinion of the Commissioner (the Respondent herein), does clearly reflect income (Sec. 41 I. R. C. 1939, Sec. 446 I. R. C. 1954).

No method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income (Reg. 1.446-1(a)(2) 1954).

The law requires that tax returns shall "clearly reflect" income. Experience has demonstrated that income

[2] The Internal Revenue Codes of 1939 and 1954 and the respective Regulations are substantially similar in regard to the issues involved in this case.

from a merchandising business cannot be "clearly reflected" on the basis of cash receipts and disbursements alone, and therefore Treasury regulations were promulgated requiring the use of inventories.

> *Aluminum Castings Co.* v. *Routzahn,* 282 U. S. 92 (1930).

"Clearly reflecting income" means an accounting method in which income is reflected with as much accuracy as standard methods of accounting permit.

> *Caldwell* v. *Comm.,* 202 F. 2d 112 (2 Cir. 1953), Aff'g 10 T. C. Memo (No. 199) 611 (1951).

To the same effect, see:

> *Boynton* v. *Pedrick,* 136 F. Supp. 888 (D. C. N. Y. 1954), Aff'd (2 Cir. 1956) 228 F. 2d 745, cert. den. 351 U. S. 938.

It was also learned that in any case in which it is necessary to use an inventory, no method of accounting in regard to purchases and sales will correctly reflect income except an accrual method. 1939 Code, Sec. 22, 1954 Code, Sec. 471.

Accordingly, Regulations regarding the accrual basis were promulgated.

> 1939 Code, Reg. Sec. 39.41-2(a);
> 1954 Code, Reg. Sec. 1.446-1(c)(2)(i).

The Regulations provide that an accrual method will be acceptable if it accords with generally accepted and recognized income tax accounting principles (Reg. 1,446-1 (c)(1)(ii) 1954 Code).

In the Appendix to the Petition for Rehearing in the Court of Appeals we have collected a number of accounting authorities holding that in a merchanding business, the cash basis is not a generally accepted and recognized income tax accounting principle, only the accrual basis will so qualify (R. 183a-189a).

Subject to the foregoing, a taxpayer may compute his income on the basis of cash receipts and disbursements, the accrual method, any other method permitted, or any combination of methods permitted by the Regulations (Sec. 446(c) 1954).

In all cases where the purchase or sale of merchandise is an income producing factor, inventories at the beginning and end of each taxable year must be taken into account in order to compute taxable income correctly for the year (Reg. 39.22(c)-1 (1939); Reg. 1.446-1(a)(4)(i)) (1954).

A special rule (so denominated by the Respondent in his Regulations) is set forth in Regulation 1.446-1(c)(2)(i) (1954), provides that in any case in which it is necessary to use an inventory, the accrual method of accounting *must be used* with regard to purchases and sales (unless otherwise authorized, which is not the case here) (Emphasis ours.) To the same effect under the 1939 Code, see Reg. 39.41-2(a).

It should be noted that *this rule is mandatory,* and not permissive.

In *Herberger* v. *Commissioner,* 195 F. 2d 293 (9 Cir. 1952) (cert. den. 344 U. S. 520), the Court said (p. 295):

> "In petitioners' business, the purchase and sale of merchandise—the purchase of cucumbers and other materials and supplies and the sale of pick-

les—were income producing factors. Therefore, in order to reflect their net income correctly, it was necessary, to take inventories of merchandise on hand at the beginning and end of each taxable year and to use them in computing their net income. See §§29.22(c)-1 and 29.41-3(1) of Treasury Regulations 111.[4] Petitioners did so take and use such inventories. Therefore no method of accounting in regard to purchases and sales correctly reflected their income except an accrual method. See §29.41-2 of Treasury Regulations 111.[5] To hold, as petitioners would have us hold, that the cash receipts and disbursements method of accounting clearly reflected their income would be to disregard §§29.22(c)-1, 29.41-2 and 29.41-3(1). This we decline to do."

---

[4] Section 29.22(c)-1 provides: "In order to reflect the net income correctly, inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase or sale of merchandise is an income-producing factor." Section 29.41-(3)(1) provides: "In all cases in which the production, purchase or sale of merchandise of any kind is an income-producing factor, inventories of the merchandise on hand (including finished goods, work in process, raw materials, and supplies) should be taken at the beginning and end of the year and used in computing the net income of the year * * *".

[5] Section 29.41-2 provides: "Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. * * * All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. * * * For instance, in any case in which it is necessary to use an inventory no method of accounting in regard to purchases and sales will correctly reflect income except an accrual method. * * *".

To the same effect, see:

Niles-Bement Pond Co. v. *U. S.*, 281 U. S. 357 (1930), aff'g 67 Ct. Cl. 693;
Becker v. *U. S.*, 21 F. 2d 1003 (5 Cir. 1927);
David W. Hughes, 22 T. C. 1 (1954);
Charles F. Bennett, 30 T. C. 114 (1958);
George L. Castner, 30 T. C. 1061 (1958).

A taxpayer on a cash basis, operating a business which requires inventories, *must report his business income on the accrual basis.*

Berryman D. Fincannon, 2 T. C. 216 (1943);
Amor W. Sharp, 12 T. C. Memo 977 (No. 299) (1953), rev'd without discussion of this point, 224 F. 2d 920 (6 Cir. 1955);
Ezo Products Co., 37 T. C. (#41) 385 (1961).

A taxpayer using an accrual method of accounting with respect to purchases and sales, may however, use the cash receipts and disbursements method in computing all other items of income and expenses (Reg. 1.446-1(c)(1)(iv)) (1954).

Accordingly, the use of the cash basis by the taxpayer in this case does not, and under the Code and Regulations, cannot, clearly reflect income, and may therefore not be used, but the taxpayer must be placed on an accrual basis in order to "clearly reflect his income" for the years 1953 and 1954 in question.

This Court has many times declared that Treasury Regulations must be sustained, unless unreasonable and plainly inconsistent with the revenue statutes.

Commissioner v. *South Texas L. Co.*, 333 U. S. 496 (1947).

Treasury Regulation 111, Sec. 29.41-2(a), the predecessor of 1939 Code Reg. Sec. 39.41-2(a) has been sustained by the Court below.

Caldwell v. *Commissioner,* 202 F. 2d 112 (2 Cir. 1953);

Herberger v. *Commissioner,* 195 F. 2d 293 (9 Cir. 1952).

In a number of cases such as this, the Court below has sustained the Commissioner in recomputing, on an accrual basis, the income of taxpayers reporting on the cash receipts and disbursements basis:

In the manufacture and sale of women's wearing apparel,

William Hardy, Inc. v. *Commissioner,* 82 F. 2d 249 (2 Cir. 1936).

In the lumber and builders' supply business,

Caldwell v. *Commissioner,* 202 F. 2d 112 (2 Cir. 1953).

In the purchase, processing and sale of sheepskins,

Boynton v. *Pedrick,* 136 F. Supp. 888 (D. C. N. Y. 1954) aff'd 228 F. 2d 754 (2 Cir. 1956) (Cert. den. 351 U. S. 938).

The Court of Appeals has sustained the Commissioner in changing a taxpayer from a cash to an accrual basis in a case where the only difference in the net result was $38.01!

Commissioner v. *Schuyler,* 196 F. 2d 85 (2 Cir. 1952).

The Commissioner's deficiency herein computed merely on the basis of disallowance of cash checks for purchases shown on the taxpayer's books, without first computing the taxpayer's taxable income on the accrual basis for purchases and sales, is arbitrary, erroneous, illegal and unreasonable, and no presumption of correctness attaches to it.

The Commissioner's determination in this case being arbitrary and erroneous, is invalid.

Greenwood v. *Commissioner*, 134 F. 2d 915 (9th Cir.);
Cohen v. *Commissioner*, 266 F. 2d 5 (9th Cir.).

The burden of adopting a method of accounting which will clearly reflect income is not only the burden of the taxpayer, but it is equally as well the burden of the Commissioner, the Respondent herein.

Bradstreet Co. of Maine v. *Commissioner*, 65 F. 2d 943 (1 Cir. 1933), rev'g and rem'g 23 BTA 1093;
Keneipp v. *U. S.*, 184 F. 2d 263 (D. C. Cir.);
Jeff Rubin, 13 T. C. Memo (#319) 1094 (1954);
Harold E. Harbin, 40 T. C. (#40) 373 (1963);
John Calamaras, 19 T. C. Memo (#201) 1045 (1960);
H. T. Rainwater, 23 T. C. 450 (1955).

By the Commissioner's own Rules and Regulations, the cash receipts and disbursements method used by the taxpayer in this case is an inadequate method; and only the accrual method will clearly reflect income. The deficiency being based on the cash receipts and disbursements method is clearly erroneous and must be set aside.

It is not the burden of the taxpayer in this proceeding to prove the amount of the deficiency, if any—that is the burden of the Commissioner, Respondent herein. The taxpayer has met his burden by showing that the deficiency is incorrect. The taxpayer is not bound to pay a tax confessedly not due, nor is he required to go further and show the amount of the deficiency or tax he owes.

Helvering v. *Taylor*, 293 U. S. 507 (1935).

To the same effect, see:

Federal National Bank of Shawnee v. *Comm.*, 180 Fed. 2d 494 (10 Cir. 1950);
Harp v. *Comm.*, 263 F. 2d 139 (6 Cir. 1959), rev'g 16 T. C. M. (#105) 431 (1957);
Welch v. *Comm.*, 297 F. 2d 309 (4 Cir., 1962), rev'g and rem'g 19 T. C. M. (#163) 855 (1960);
Grubb v. *Comm.*, 315 F. 2d 753 (6 Cir. 1963), rev'g and rem'g 20 T. C. M. (#153) 756 (1961).

Court of Appeals' Opinion

With all due deference to the Court of Appeals, Petitioner would like to point out briefly some of the errors which were made by the Court.

1. First, the Court stated at the top of page 894 of its opinion (R. 150a) that "Eugene's net income should be *decreased* for 1953 and *increased* for 1954" by the amount of the K & L net credit of $17,709.32 for 1953 and net debit of $11,789.36 for 1954.

Then the Court proceeded to show that by "substitution" of the K & L ledger figures for the figures in the

Sperling books a result substantially less favorable to the Petitioner.

It is respectfully submitted however, and with all due respect to the Court, that the Court did not "substitute" K & L figures for Sperling's. On the contrary, the Court *added* K & L's figures to Sperling's figures as follows:

1953

K & L Books—Net Credit	17,709.32
Sperling's Books—Net (Cash) Sales to K & L	28,503.68
Total (arrived at by Court)	46,213.00

1954

K & L Books—Net Debit	11,789.36
Sperling's Books—Net (Cash) Purchases from K & L	33,405.27
Total (arrived at by Court)	45,194.63

Since the two sets of K & L figures are supposed to represent Sperling's sales in one case, and Sperling's purchases in the other, it is respectfully submitted that the smaller figures are already included in the larger figures, and should be deducted in order to *substitute* the figures. The failure to deduct the smaller figures from the larger figures, but *adding* them instead, *increases the error.*

It is respectfully submitted that a correct "substitution" of the K & L ledger figures for those of Sperling can

only be made by *deducting* the smaller K & L figures, as follows:

1953	
Sperling's Books—Net (Cash) Sales to K & L	28,503.68
Deduct:	
K & L's Books—Net Credit	17,709.32
Decrease of Sperling's Sales & Net Income	10,794.36
1954	
Sperling's Books—Net (Cash) Purchases from K & L	33,405.27
Deduct:	
K & L's Books—Net Debit	11,789.36
Decrease of Sperling's purchases and increase in Income	21,615.91

Thus, the substitution of K & L figures for Sperling's results in decreasing Sperling's 1953 income by $10,794.36 and increasing 1954 by $21,615.91, not $46,213.00 and $45,194.63, as stated by the Court.

However, with all due respect to the Court, it is respectfully submitted that the substitution of the above K & L figures for those of Sperling is still erroneous in that while the Sperling figures consist of Purchases and Sales solely of Metals (although made by cash, in accordance with the cash basis of Sperling's books), the K & L figures used by the Court comprise both cash *and* metals. Thus the figures are *not* comparable.

A proper *substitution* of the K & L ledger figures of metals for the Sperling figures of metals is as follows:

	1953	*1954*
K & L Books—Metals sold to Sperling	165,394.00	109,655.54
Sperling Books—Metals purchased from K & L	56,672.67	108,405.27
Difference	108,721.33	1,250.27
Add: Processing Expenses—Net	7,552.94	6,248.61
Total Difference	116,274.27	7,498.88
K & L Books—Metals purchased from Sperling	90,535.04	59,539.73
Sperling Books—Metals Sold to K & L	85,176.35	75,000.00
Difference	5,358.69	
Difference		(15,460.27)
Increase in cost of goods sold and decrease in income	110,915.58	
Decrease in cost of goods sold and increase in income		(7,961.39)

2. It is respectfully submitted that the Court is in error in concluding that the processing expenses are "subsumed" in the metals account as stated at the bottom of page 894 (R. 150a) of its opinion. These expenses are over, above and in addition to the cost of the metals and should be added to them.

3. The foregoing discrepancies between Sperling's books on a cash basis and K & L's books on the accrual basis, show that the Court's conclusion that the discrepancy between Sperling's cash method and K & L's accrual basis is not $1,000—a fraction of 1% as stated at the top of page 895 (R. 151a)—but over $100,000, a very substantial discrepancy.

In *Commissioner* v. *Schuyler*, 196 F. 2d 85 (2 Cir. 1952), the Court below redetermined a deficiency where the only difference was not $1,000, but $38.01.

What discrepancy would result if all of Sperling's transactions, not only those with K & L, were placed on an accrual basis, is unknown. (As the Tax Court said, "it would be artificial to put Eugene on an accrual basis as regards only this one supplier" (R. 118a).

4. On page 895 (R. 151a), the Court's opinion shows that in a mercantile business the accrual basis is mandatory, and then states that the Commissioner "could properly have used the accrual method", and then (at the top of page 896) (R. 152a) that the Petitioner could have done likewise; as though the accrual basis were permissive, instead of mandatory in this case.

We are at a loss to understand how the Court below now holds that the accrual basis is permissive in the face of the Internal Revenue Code and the Regulations of the Respondent himself since 1918, making the accrual basis in this case mandatory, and in the face of the prior decisions of the Courts of Appeal and the prior decisions of this Court, all holding that in a mercantile business a tax return on a cash basis will not "clearly reflect income"; that only the accrual basis can properly reflect income under these circumstances.

> "* * * when a business is carried on mainly through sales on credit no return of income and

profits for a taxable year is accurate and complete without considering the accounts receivable,

* * * An examination of the returns and the accountant's reports shows that the books have been kept on the accrual basis, that it has accounts receivable and that inventories have been taken, that the corporation did not use such inventories and accounts receivable in the computation of net income but filed its returns on the basis of actual receipts and disbursements.

* * * Article 92 of Regulations 33, revised, * * * provides that inventories shall be used in the computation of net income by mercantile or trading corporations. The form of return prescribed for the use of such corporations provides that inventories shall be used; it also requires that the gross sales shall be entered on the return, and in order that this item may be correctly stated the accounts receivable, if any, must be included.

* * * Inasmuch as the Income Tax Unit has adopted the general plan outlined by the law and regulations with respect to mercantile corporations, it is the opinion of the Committee that the action taken in this case was proper, and that in order to correctly reflect the true income of this corporation both inventories and accounts receivable must enter into the computation of the net income.

* * * requiring this corporation * * * to take into consideration in the computation of its income both inventories and accounts receivable was proper and in accord with the law and regulations on this subject."

A. R. R. 217, 3 Cum. Bull. 76, 78-79 (1920).

In *Aluminum Castings Company* v. *Routzahn*, 282 U. S. 92, at page 97, this Court said:

> "Experience demonstrating that income derived from merchandising and manufacturing businesses could not be computed on the basis of receipts and disbursements alone, Treasury Regulations were promulgated requiring the use of inventories in proper cases, and permitting the deduction of accounts payable when accounts receivable were brought into the income account."
>
> "* * * keeping accounts and making returns on the accrual basis as distinguished from the cash basis, import that it is the *right* to receive and not the actual receipt that determines the inclusion of the amount in gross income. When the right to receive an amount becomes fixed, the right accrues. When a merchandising concern makes sales, its inventory is reduced and a claim for the purchase price arises. Article 35 of Regulations 45 under the Revenue Act of 1918 provided: 'In the case of a manufacturing, merchandising or mining business, 'gross income' means the total sales, less the cost of goods sold, plus any income from investments and from incidental or outside operations or sources'.
>
> On an accrual basis, the 'total sales', to which the Regulation refers are manifestly the accounts receivable arising from the sales, and these accounts receivable, less the cost of the goods sold, figure in the statement of *'gross income'*. (Emphasis in the original.)
>
> This provision has been carried forward in the regulations under the later revenue acts. See Regulation 77, Article 55.

Spring City Foundry Co. v. *Commissioner,* 292 U. S. 182, 184, 185."

In *Caldwell* v. *Commissioner,* 202 F. 2d 112, 114, the Court below said:

> "The use of inventories in computing income results in stating the expenses of the year's operations in terms of the cost of the goods actually sold during that year. Thus, the profit from these operations will be stated accurately only if the income from all sales made during the year is taken into consideration. *This requires use of the accrual method of determining income,* since the cash receipts method obviously does not reflect the actual sales made during the year where, as in the present case, a substantial part of the sales—from 90 to 95 percent, according to the findings—is made on credit." (Emphasis added.)

In the case at bar, the record shows that the cash purchases and sales vary between zero and 13 percent, and that consequently, the business on credit varies between 87 and 100 percent.

In *Commissioner* v. *Dwyer,* 203 F. 2d 522, at page 523, Judge Learned Hand in speaking for the Court (Judge Swan, concurring) said:

> "When a merchant is selling from, and buying for, a stock of merchandise, at first blush it might seem proper to compute his income in any year by charging him with the proceeds of his sales and crediting him with the cost of his purchases; and that would indeed be correct as to articles that he sells in the same year in which he has bought them; but it would not be correct as to articles that he

> sells in a later year. The cost of an article is never, as such, a deductible expense of the business; it is one factor—the subtrahend—of an equation that fixes the profit or loss, and profit or loss should figure the merchandise income, either as a charge or as a deduction. Obviously, the equation cannot be computed until the article is sold, and it follows until then its cost ought to be carried in suspense. * * * it followed that, although as to articles bought and sold in the same year, his tax returns were right, they were wrong as to articles carried over from earlier years, unless it so chanced that the aggregate cost of the articles bought in the year in question was the same as those carried over and sold in that year—a negligible possibility. His income had been understood so far as the costs of the articles carried over and sold had been less than that of the articles bought, and vice versa."

In *Boynton* v. *Pedrick,* 136 Fed. Supp. 888, aff'd 228 F. 2d 745, cert. den. 351 U. S. 938, Judge Murphy stated, on page 891:

> "* * * Both the Herberger and the Cauldwell cases sustained the validity of the Regulation 29.41-2. It is not quite clear whether in those cases the cash receipts and disbursement method was held to 'not clearly reflect the income' as a matter of law or on the basis that a correct factual finding had been made by the Tax Court. *In my opinion the cash receipts method as a matter of law does not clearly reflect income here."* (Emphasis ours.)

In the Appendix to the Petition for Rehearing in the Court of Appeals we have collected a number of accounting authorities holding to the same effect as above, namely, that in a merchandise business the cash basis will not clearly reflect income, only the accrual basis.

With all due respect to the Court, we submit that the decision of the Court holding the accrual basis permissive instead of mandatory in this case is a grave error and contrary to all of the authorities cited, including the prior decisions of this Court.

5. On page 896 (R. 152a) the Court states:

> "The petitioner has made no attempt to show that use of the accrual method would reduce rather than increase the deficiency."

It is respectfully submitted to the Court that in no case in which the Commissioner was sustained in his use of the accrual method in similar circumstances, was he compelled to show that the accrual basis would increase rather than decrease the taxpayer's income. It is not incumbent upon the Commissioner to show that the accrual basis will increase the taxpayer's income rather than decrease it for the simple reason that the cash basis does not clearly reflect income.

It is submitted that the same logical reasoning applies so far as the Petitioner is concerned: since the cash basis "does not clearly reflect income" no further proof is necessary to compel the use of the accrual basis in a mercantile business which is the only method which will "clearly reflect income."

While the Tax Court recognized

> "the difficulties of petitioner under the circumstances—the lapse of time, inadequate books and records, Eugene's death, the unavailability of witnesses, black market payments of which there would probably be scant record by the recipient—"

it made no allowance therefor.

However, despite the fact that Petitioner submits it is not incumbent upon him to prove this, nevertheless we submit that the proof thereof is self evident in the figures

shown above, where the discrepancy between the Sperling books and the K & L books in the purchase of metals in the years 1953 and 1954 show a decrease in Petitioner's income of over $100,000.

6. The Court states on page 896 (R. 152a) that the Commissioner may work within the framework of the taxpayer's own improper accounting system.

We submit that this is an erroneous theory. This is a false premise when the cash basis used by the taxpayer in a mercantile business is an improper basis.

As already shown the cash basis does not show the true result of operations, since income and expenses of a prior year may be included in the current year, or excluded from the current year and included in a subsequent year or years; one year might show a net gain, and the next year a net loss, when, as a matter of fact, the operations of the two years were the same, except for the dates of the cash receipts and disbursements (see Appendix to Petition for Rehearing below, p. 18).

It is only by mere coincidence that the results on the cash basis and the accrual basis in any one year would be the same (see Appendix to Petition for Rehearing below, p. 18).

On the argument of this case in the Court of Appeals we gave the following example of the result of the Commissioner's action in this case:

Assuming:	*Cash Basis*	*Accrual Basis*
Taxpayer's Net Income	Profit 50,000	Loss 50,000
Disallowance by the Commissioner of roughly $50,000 cash purchases here involved	50,000	50,000
Result:	Profit 100,000	–0–

Obviously, under these circumstances the Commissioner is taxing the taxpayer on the basis of $100,000 income computed on a cash basis when in fact he had no income whatsoever, as the accrual basis shows.

We might give another example, reversing the above figures thus:

Assuming:	*Cash Basis*	*Accrual Basis*
Taxpayer's Net Income	Loss 50,000	Profit 50,000
Disallowance by the Commissioner	50,000	50,000
Result	–0–	Profit 100,000

Obviously, under these circumstances the taxpayer would escape a tax on the $100,000 profit on the accrual basis, since the cash basis shows no profit or loss.

Now, if we might give just one more example as follows:

Assuming:	*Cash Basis*	*Accrual Basis*
Taxpayer's Net Income	Profit 25,000	Loss 25,000
Cash Purchases disallowed	50,000	50,000
Result	Profit 75,000	Profit 25,000

In this case the taxpayer would be taxed on $75,000 profit instead of $25,000, the actual profits.

We submit that disallowing the cash purchases without first redetermining the taxpayer's net income on the accrual basis is erroneous and improper

7. At the bottom of page 896 (R. 152a) the Court states that "the Petitioner has cited no case directly supporting his contention that this burden should be placed on the Commissioner".

We submit that the Court below overlooked the authorities cited by the Petitioner on pages 11 and 12 of his Main Brief, that this burden is not only the burden of the taxpayer, but equally as well the burden of the Commissioner, and the cases cited for that proposition of law starting with *Bradstreet Co. of Maine* v. *Commissioner,* 65 F. 2d 943 (1st Cir. 1933) (p. 17, *supra*).

The Court's reference at the bottom of page 896 (R. 152a) to the Petitioner's citations as merely upholding the Commissioner's power to require the accrual method (because the cash basis does not clearly reflect income), are equally as well authority for the Petitioner to require the Commissioner to use the accrual method since the cash basis does not clearly reflect income.

It is not the Petitioner who places this burden on the Commissioner; it is the Commissioner who must assume this burden if he wants to assess a deficiency, since in order to determine the amount of the deficiency against the taxpayer, the first step is to determine the amount of the taxpayer's net income, and this can only be done if the Commissioner first places the income on an accrual basis.

In *Elmer D. Willis,* 16 T. C. M. (#223) 1013 (1957), a partnership bought and shipped seafood, and bought and sold clams for its own account, but kept no books and records except copies of shipping memorandums. They filed partnership returns which showed only the best estimate of what the income had been. In determining the deficiencies, the Respondent took the total amount

of shipping memorandums for each year as the partnership sales and used a percentage for the amount of purchases for one year, and determined purchases for two other years from cancelled checks and cash withdrawn. He did not allow some checks which he could not identify as purchases and did not allow some customers' checks which were cashed and used for purchasing merchandise. The Court found the taxpayers were grossly negligent in disregarding the requirements of law which required them to keep books and records sufficient to establish their income, and therefore the Respondent was justified in determining their income "in accordance with such method as in * * * his opinion * * * did clearly reflect the income." The Court there said (p. 1015):

> "* * * But, *despite* our appreciation of *the difficult burden which these petitioners placed upon the respondent by their negligence,* we nevertheless think that he also erred in the method by which he determined the respective shares of partnership income and the resulting deficiencies in the petitioners' individual incomes.
>
> The wide discretion given to the respondent by section 41, to determine the correct amount of tax owed by a taxpayer who does not keep adequate books and records, has never presupposed the privilege of disregarding the best available evidence and a more accurate method of determining the amount of income, in preference for other evidence and some other method which will result in the largest possible amount of tax. On the basis of the whole record before us here, *we think the method by which the respondent determined the petitioners' income did not clearly reflect such income. We think there was other available evidence on which a determination could have been based*

which would have more nearly approximated the amounts of income which we believe these petitioners actually received.

* * * * *

We think on the basis of all the evidence available to him that the respondent selected a method for determining the distributive shares of partnership income which obviously was not based upon the best evidence available, and that such method was not one which clearly reflected the petitioners' income. We therefore cannot sustain his determination of deficiencies insofar as they relate to the distributive shares of partnership income." (Emphasis supplied.)

We believe the situation in the case at bar is similar to that in *Willis*, and that the same result should follow as the decision in that case, and that accordingly, the deficiency for the years 1953 and 1954 should be set aside as arbitrary, erroneous, illegal, unreasonable and invalid.

8. In *Helvering* v. *Taylor*, 293 U. S. 507, this Court held that this Court of Appeals was correct in reversing a Board of Tax Appeals determination which it found excessive, even though the taxpayer offered no evidence in the proceedings before the Board, to show the correct deficiency. The Supreme Court said:

> "We find nothing in the statutes, the rules of the Board, or our own decisions, that give any support to the idea that the Commissioner's determination shown to be without rational foundation and excessive will be enforced, unless the taxpayer proves that he owed nothing, or if liable at all, shows the correct amount."

The finding of a deficiency in this case is the same as though the taxpayer had no net income, but in fact a loss, and yet the Commissioner on disallowing cash purchases taxed the taxpayer on the full amount thereof, without first giving him credit for the loss which he sustained.

The deficiency under these circumstances is undoubtedly without a "rational foundation" as stated by the Court in *Taylor* above.

The Commissioner's failure to determine the taxpayer's net income on the accrual basis is so grave an error as to *fatally* "infect" the deficiency.

9. We are unable to understand the meaning of the Court's opinion in the middle of page 897 where it states "the only apparent relation (between the Petitioner's inability to document certain alleged costs, and the alleged 'error' of the Commissioner's failure to redetermine the liability using the cash method) is that the difference between the cash and accrual methods is one reason for regarding the K & L ledger account as unsatisfactory evidence of Eugene's net costs."

We submit that Eugene's cash basis books are unsatisfactory evidence of his costs, but that K & L's ledger account, on the accrual basis, *is* satisfactory evidence of Eugene's net costs; but only insofar as his transactions with K & L are concerned. The transactions of all his other customers and creditors must likewise be placed on the accrual basis.

10. The Court says, on page 897 (R. 153a) that the Commissioner and taxpayer are both required to use "reasonable" accounting methods.

We submit, that, as shown above, the law is now too well settled to require the use of "reasonable" accounting

methods under the circumstances of this case. In this case the law permits only one method, and that is the accrual method.

We respectfully submit to the Court that the cases cited by the Court below on page 897 (R. 153a): *Jeff Rubin,* 13 T. C. M. 1094 (1945), *Keneipp* v. *U. S.,* 184 F. 2d 263 (D. C. Cir. 1950) and *Elmer D. Willis,* 16 T. C. M. 1013 (1957), were determined, not on the basis of the substitution by the Commissioner of his own accounting method, but because of his failure to use the accrual method.

We submit that the taxpayer here does not have a "rational though improper system," because it is mandatory that he use the accrual basis. The law does not permit the Commissioner to tax a taxpayer on the disallowance of cash purchases alone, without first determining his true net income or loss on the accrual basis in order to determine the true *taxable* net income of the taxpayer.

We submit that the judgment and opinion of the Court of Appeals *are clearly erroneous.*

Reasons for Granting the Writ

1. The decision of the Court of Appeals below is directly in conflict with the decisions of this Court, cited *supra.*

2. The decision is likewise in conflict with and contrary to, all of the other decisions of the Second Circuit on the same issue as in this case, cited *supra;* and it is also in conflict with the decisions of the Courts of Appeals of other Circuits cited.

3. The question presented herein is of importance in the administration of federal tax cases and settlement of the issue is in the public interest.

4. The case is representative of a problem confronting many taxpayers. There have been many such cases heretofore, as the cases cited show, and undoubtedly there are many cases presently existing, and there will unquestionably be many such cases arising in the future.

5. The Internal Revenue Service has since 1918 always taken the position (except in this case) that a taxpayer dealing in merchandise, must take inventories and keep his books on an accrual basis, in order to "clearly reflect (his) income," since no other method will do so.

6. Accordingly, it is respectfully submitted that a fundamental reason for granting the writ, aside from the petitioner's position, lies in the fact that the issue is a continuing one and affects a large number of taxpayers, who are generally in low brackets and can ill afford the costs of litigation. It is therefore in the interest of the government as well as the many taxpayers involved that the issue be definitively and authoritatively resolved by this Court.

Conclusion

It is undisputed that the taxpayer herein dealt in merchandise and was required to and did, account for his inventories. Consequently he should have kept his books on the accrual basis. It is undisputed that he did not keep his books on the accrual basis, but on the contrary kept them on the cash receipts and disbursement basis. The cash basis is improper, and not permitted, because it does not "clearly reflect income," and only a method of accounting which "clearly reflects income" is acceptable in compliance with the Internal Revenue regulations.

Experience has demonstrated that income from a merchandise business cannot be clearly reflected on a cash receipts and disbursement basis, and therefore the Treasury promulgated regulations requiring the use of inventories and the accrual basis.

The accrual basis is not permissive. It is *mandatory.*

Since the income tax is a tax based on income, determination of a taxpayer's net income is the first step necessary for the computation and determination of the tax.

Since the taxpayer maintained his books on a cash receipts and disbursement basis, and determined his so called net income on that basis, it is obvious this is not his *taxable net income*, which can only be determined on the accrual basis.

The burden of adopting a method of accounting which will clearly reflect income is not only that of the taxpayer, but equally as well the burden of the Commissioner, without which a valid deficiency cannot be made.

Nevertheless, the Respondent herein has determined a deficiency, merely by taxing the amount of cash purchases disallowed, instead of first computing the taxpayer's true net income, which can only be done by first placing his books on the accrual basis.

Consequently the deficiency is clearly erroneous, arbitrary and invalid.

It is not, however, the burden of the taxpayer to prove the amount of the deficiency, if any,—that is the burden of the Commissioner. The taxpayer has met his burden by showing that the deficiency is incorrect. He need not go further and show the amount of the deficiency or tax he owes.

With all due respect to the Court of Appeals below, we submit that we have clearly shown herein that the opinion of the Court of Appeals is *clearly erroneous,* and consequently the judgment of the Court of Appeals below should be reversed.

Since the judgment of the Court of Appeals is in conflict with the decisions of this Court, its own prior decisions on the same issue, and in conflict with other Courts of Appeal, and contrary to the Internal Revenue Code and Regulations, and the long time Rulings of the Internal Revenue Service, and in view of the importance of the question in the administration of Tax law, it is respectfully submitted, that it is in the public interest that this case should be reviewed by this Court, and an authoritative determination be made.

It is respectfully submitted that the Court below has so far departed from the accepted law in cases of this kind as to call for the exercise of this Court's power of supervision.

For all of the foregoing reasons, it is respectfully submitted, that this petition for a writ of certiorari should be granted.

Respectfully submitted,

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